

EMPLOYMENT TAXES: RETURN INFORMATION OF MISCLASSIFIED EMPLOYEES IS DISCOVERABLE IN A WORKER CLASSIFICATION CASE

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Employers are required to deduct federal income tax from employees' paychecks. I.R.C. § 3402(a)(1). While the employer will be liable if it fails to withhold, I.R.C. § 3403, in cases where the employees were improperly classified as independent contractors, the prospect exists that they have independently paid their income taxes directly after receiving a 1099. As a consequence, the Internal Revenue Code provides a partial defense to the employer: The employer will not be liable for income taxes to the extent that the improperly classified employees paid them, but will remain liable for any interest and penalties associated with its failure to deduct the taxes from the employees' wages. I.R.C. § 3402(d).

One way to establish that the taxes were paid is to request that the relevant workers execute [IRS Form 4669](#), acknowledging the payments that they received and indicating the taxes that they paid. The IRS will generally accept these forms to support the employer's defense to the payment of income tax. IRM 4.23.8.4.2 (12-11-2013). But workers no longer affiliated with the business have no particular reason to cooperate with the employers, and some former workers may be difficult to locate.

On April 5th, the Tax Court issued an opinion holding that an employer could seek return information from the IRS to support its potential defense under section 3402(d) of the Code. [Mescalero Apache Tribe v. Comm'r](#), Docket No. 28120-14, 2017 U.S. Tax Ct. LEXIS 12 (April 5, 2017).

To put this decision in context, it is important to understand that tax returns and the data that they contain are afforded a high degree of confidentiality under federal law. Specifically, federal officers and employees, a variety of state and local officials, and a number of others who are afforded access to tax returns and return information are barred from disclosing tax information. I.R.C. § 6103(a). Violations of this requirement can create civil liability or result in criminal prosecution. See I.R.C. § 7213(a) (providing that unauthorized disclosure is a crime); see also I.R.C. § 7431(a) (creating civil cause of action for damages). For practical reasons, there are a variety of exceptions to the basic confidentiality requirement.

In *Mescalero Apache Tribe*, the tribe was involved in a worker classification dispute; for a variety of reasons, it was not able to secure copies of Form 4669 from a significant number of the affected workers. Since the relevant information was in the files of the IRS, it sought discovery of the tax payments made by the relevant workers, but the IRS balked, arguing that it was barred from providing the information by section 6103 of the Code. 2017 U.S. Tax Ct. LEXIS 12 at *4-*5. The tribe invoked section 6103(h)(4) of the Code, which authorizes disclosure of returns and return information judicial and administrative tax proceedings.

The Tax Court commenced its analysis by identifying a Circuit split on whether returns and return information could only be disclosed to officials of the Department of Treasury and the Department of Justice. While the Fifth Circuit had limited disclosure to governmental officials in *Chamberlain v. Kurtz*, 589 F.2d 827, 837-38 (5th Cir. 1979), the Tenth Circuit had rejected that approach in *First W. Gov't Sec. Inc. v. United States*, 796 F.2d 356, 360 (10th Cir. 1986). Since the tribe was located in New Mexico, the Tax Court elected to follow the Tenth Circuit approach under *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), because the Tenth Circuit would likely hear any appeal. 2017 U.S. Tax Ct. LEXIS 12 at *7 & n.5.

In analyzing the tribe's ability to obtain the data on tax payments, the court focused on section 6103(h)(4)(C) of the Code, which authorizes disclosure of returns or return information if the information "directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding." I.R.C. § 6103(h)(4)(C). Here the court initially concluded that the relationship between the tribe and its workers was a "transactional relationship" that fell within the scope of section 6103(h)(4)(C). 2017 U.S. Tax Ct. LEXIS 12 at *9-*10.

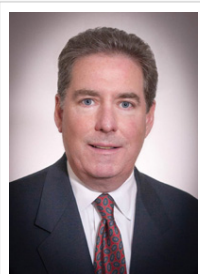
Next, the Tax Court addressed whether data on tax payments by the tribe's workers "directly relate[d]" to their "transactional relationship" with the tribe. The court found this standard was readily met as information on whether the workers paid their taxes was directly relevant to whether they considered themselves independent contractors or employees and, consequently, directly related to their relationship with the tribe. *Id.* at *10-*11. The Tax Court then concluded that the relevant return information would "directly affect[] the resolution of an issue in the proceeding," under section 6103(h)(4)(C) because it was relevant to the classification dispute in general and to the tribe's defense under section 3402(d). *Id.* at *12.

Although the Tax Court's conclusion that the return information was subject to disclosure would seem to have ended the dispute, it did not. Remarkably, the government also argued that the tribe could not obtain the information through discovery because it was the tribe's burden to establish that the taxes were paid. *Id.* This assertion got the short shrift it deserved, as the court noted that its rules explicitly provided that the burden of proof was irrelevant to the determination that information was discoverable. *Id.* at *13 (citing Tax Ct. R. Prac. & Pro. 70(b)). For good measure, the court observed that the language of section 3402(d) of the Code appeared to impose responsibility on the IRS to review its own records to assure it did not attempt to collect the same tax twice. *Id.* at *13 n.6.

The Tax Court's opinion is well-reasoned and should apply broadly in future cases, with the exception of cases that would be appealable to the Fifth Circuit, where the narrower reading of section 6103(h)(4) applies. That is good news for employers in classification cases who now have a clear path to obtain relevant information bearing on the extent of their liability.

The opinion is surprising for two reasons:

- It seems odd that the court has apparently never addressed this issue before.
- The conduct of the IRS is more than a little disturbing, as it apparently made no effort whatsoever to determine whether the tribe's workers had already paid the relevant taxes.



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